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IN THE

Supreme Court of the United States

OCTOBER TERM—1944

No. 612

SPENCER, WHITE & PRENTIS, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

Spencer, White & Prentis, Inc. respectfully submits this petition and prays that a writ of certiorari issue to review the decision and mandate of the United States Circuit Court of Appeals for the Second Circuit herein which affirmed an order of the Tax Court of the United States which in turn "Ordered and Decided: That there are deficiencies in income and excess profits tax in the amounts of $79,824.41 and $34,049.38 respectively for the fiscal year July 1, 1937, to June 30, 1938."

Opinions Below

The Memorandum Findings of Fact and Opinion of the Tax Court of the United States are dated June 21, 1943, and a copy thereof is hereunto annexed made a part hereof, and marked Appendix A.

The Opinion of the United States Circuit Court of Appeals for the Second Circuit is dated July 10, 1944, and a copy thereof is hereunto annexed made a part hereof and marked Appendix B.

Summary Statement of the Matters Involved

This proceeding concerns a proposed deficiency in income and excess profits taxes sought to be sustained by respondent against petitioner for its fiscal period July 1, 1937—June 30, 1938.

The letter of respondent claiming such deficiency is dated June 6, 1941. From such proposed adjustment of petitioner's tax liability, petitioner appealed to the Tax Court of the United States by petition verified August 18, 1941.

From the determination of the Tax Court petitioner appealed to the United States Circuit Court of Appeals for the Second Circuit by petition verified September 8, 1943.

The said Circuit Court of Appeals sustained the action of the Tax Court herein.

Petitioner moved for reargument on July 20, 1944, which motion the Circuit Court of Appeals denied without opinion by order dated July 26, 1944.

Jurisdiction

The mandate of the Circuit Court of Appeals for the Second Circuit was entered herein on July 27, 1944. The jurisdiction of this Court is founded on Section 347-a of the United States Judicial Code.

The Facts Herein

The facts herein, insofar as a recital thereof is necessary to an understanding of the questions involved herein are as follows:

Petitioner is a contracting corporation which regularly performs short term construction contracts and from time to time performs long term construction contracts. It has always reported its income on the annual accrual basis.

In 1933 it was engaged in performing a long term construction contract for the United States along the Mississippi River. The form of such contract resulted in its being prepaid in one period for construction work it was obligated to perform in a later period.

It then (1933) applied to respondent for permission to report its long term contracts on a completed contract basis. The Commissioner denied this application on two grounds: (a) that it was not made within a ninety-day period after the close of petitioner's fiscal period, (b) that "an election with respect to the basis of reporting income from each separate long-term contract is no longer permissible."

It thereupon, for 1933-1934 reporting, accrued all of the income earned by it, that is, the value of all work performed by it, including the value of work performed and not certified and the amount of net retained percentages, and returned the sum of these as assets and income.

It also, for 1933-1934 reporting, accrued all liabilities, including the cost of performing the work for which it had been prepaid. These it returned as liabilities and expenses.

In the above manner of reporting respondent acquiesced.

On June 30, 1938 petitioner was faced with the identical situation it faced in 1933-1934. At this time the contract in question was a New York City subway contract. It was then pointless to again apply to the respondent for leave to report the contract in question as a long-term construction contract. In its reporting for the fiscal period ending June 30, 1938, petitioner reported exactly as it did as of June 30, 1934.

It reported as assets and income

(a) Moneys earned under contract certified and paid	$3,002,303.34
(b) Money earned under contract certified but retained by the City of New York pursuant to the contract	529,818.24
(c) Money earned under contract but not yet certified	321,519.85

It reported as liabilities and expenses:

(a) Costs paid and accrued (as to these items there is no question)	2,860,110.76
(b) Expenses and liabilities accrued	327,500.00

Said item of $327,500 was the estimate of the cost of performing the work for which petitioner had been prepaid under the contract in question.

Respondent conceded that the accrual of $327,500 was an accurate and reasonable estimate, but disallowed the same as a deduction for the year in question.

Petitioner's evidence before the Tax Court, as the record shows, was substantially unquestioned and was amply corroborated by documentary evidence.

The opinion of the United States Circuit Court of Appeals Second Circuit sets forth these facts as follows:

> "The total of $3,853,641.43 included by the taxpayer as gross income in its return for the fiscal year in question covered not only the contract price for pay items completed but some non-pay items yet to be performed. This resulted from the fact that the cost of non-pay items was included in the cost of pay items.
>
> "The taxpayer accrued on its books* as of June 30, 1938, the sum of $327,500 as a 'liability to restore property under contracts' which was the estimated

* This is the language used in the income tax return Pet.'s Ex. 1. The books carry this as "Contract 761 Deferred for incurred expense as of 6/30/38 on Route 101 Sec. 6, as estimated by E. A. Prentis, Chief Eng. as follows * * *" Pet.'s Ex. 17.

cost of items which it had carried in its accrual of gross income. This amount of $327,500 it deducted in its tax return as 'increased* expenses.' But this amount did not represent obligations due to sub-contractors, materialmen, laborers or other creditors and was an estimate of the cost of work under the contract performed after June 30, 1938, at a cost of $339,090.40."

Questions Presented

This application brings before this Court departures by the Tax Court of the United States and the Circuit Court of Appeals for the Second Circuit from principles well established and followed by this Court as to the construction of Sections 21, 23, 41, 42 and 43 of the Revenue Act of 1936 (similar in prior and subsequent Revenue Acts) and Regulations 94 Article 21 (d), 23 (a)-1, 41-1, 41-2, 41-3, 43-1 and 43-2 and I. T. 1273. While an income tax case, it involves questions primarily of statutory construction, rather than of accounting.

In detail, the questions presented are:

1. May an obligation to render services (as distinguished from an obligation to pay money), be the basis of an accrued liability?
2. May "a fair estimate" of future costs be the basis of an accrual deduction?
3. Is a decision of the Tax Court properly affirmed when it is predicated upon major and vital findings of fact directly contrary to the unquestioned documentary evidence in the case?
4. Was petitioner's method of accounting and reporting for the year in question consistent with its manner of accounting and reporting for prior years?
5. Was the Tax Court obliged to determine the correct measure of both income and expense for the year in question?

* So in Original.

Statutes and Regulations Involved

The statutes and regulations involved herein as above described are set forth in Appendix C hereof.

Specifications of Errors to be Urged

The Circuit Court of Appeals erred:

1. In holding that an obligation to render services (as distinguished from an obligation to pay money) may not be the basis of an accrued liability.
2. In holding that a fair estimate of future costs may not be the basis of an accrual deduction.
3. In affirming a decision of the Tax Court predicated upon major and vital findings of fact directly contrary to the unquestioned documentary evidence.
4. In holding that proof of the use of a method of accounting and reporting income from long-term construction contracts used by petitioner in 1933-1934 under identical conditions existing in 1937-1938 is not proof of consistency of method of reporting in 1937-1938.
5. In holding that the Tax Court was not obliged to determine the correct measure of both petitioner's income and expense for the year in question.

The Reasons Relied on for the Allowance of the Writ.

1. The Circuit Court of Appeals, Second Circuit has decided a Federal question (i. e. under a Federal tax statute) in a way probably in conflict with decisions of this Court.

Before the Tax Court and the Circuit Court petitioner contended that an obligation to render services (as distinguished from an obligation to pay money) is a proper basis of an accrued liability.

and

> "A fair estimate of future costs may be the basis of an accrual deduction."

On these points the Circuit Court held:

> "Here the work for which the deduction is sought was unperformed and its cost was, as we have already indicated, no more than a fair estimate. Such a deduction as the taxpayer seeks had not 'accrued during the taxable year' and, therefore, did not meet the requirements of Section 23 (a) of the Revenue Act of 1936."

It is respectfully submitted that this holding is in conflict with the holding of this Court in *United States* v. *Anderson*, 269 U. S. 422 (1926). In that case a taxpayer on the accrual basis entered in 1916 a reserve for taxes on munitions made and sold in 1916. The taxes were not assessed, did not become due, and were not exactly computed until 1917. The Supreme Court held that said reserve was properly deductible in 1916.

The Court stated at page 440:

> "* * * The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year, the total costs and expenses attributable to the production of that income during the year. The reserve for munition taxes set up on its books for 1916 must have been deducted from receivables for munitions sold in that year before the net results of the operations for the year could be ascertained."

At page 441, the Court stated:

> "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decisions were concerned, the taxes had accrued."

The decision of the Circuit Court of Appeals, Second Circuit, is also in conflict with the decision of this Court in the case of *American National Co.* v. *United States*, 274 U. S. 99 (1927); (usually cited in connection with the *Anderson* case).

This case concerned an agreement to pay a bonus during the life of discounted notes. A deduction was allowed for a reserve for bonuses payable in future years, under contracts made in taxable year.

In the instant case the liability to perform the prepaid work without further compensation was admitted and fixed in the year of the prepayment and, obviously, these expenses of performing said prepaid work were attributable to the production of the prepaid income. Hence under the rule of the *Anderson* case such expenses "must have been deducted from" the prepaid income "before the net results of the operations for the year could be ascertained." With this rule the opinions below are in conflict.

2. The Circuit Court of Appeals, Second Circuit has decided a Federal question in conflict with the decisions of other Circuit Courts of Appeal on the same questions.

By forcing petitioner to postpone deduction of the expenses of performing the prepaid work until said expenses were actually incurred, the Circuit Court has limited petitioner to a cash basis method of reporting these expenses, whereas the prepaid income was reported on the accrual basis.

It is respectfully submitted that the decision of the Circuit Court of Appeals, Second Circuit is in conflict with the decisions of the following Circuit Courts on the same questions:

Fourth Circuit:

Bonded Mortgage Co. of Baltimore v. *Commissioner*, 70 F. 2d, 341, C. C. A. 4, 1934.

In that case the Court stated at page 342:

> "The taxpayer's principal contention here is that the treatment of its income and out-go must be similar; * * * or, in other words, that both sides of the taxpayer's ledger must be treated alike; * * *
>
> "We are clearly of the opinion that the taxpayer's main contention is sound. Both sides of the ledger must be treated alike; otherwise its true income will not be reflected by the accounting * * *"

and at page 343:

> "* * * If, as illustrated by these cases, the taxpayer is not permitted to adopt inconsistent methods of bookkeeping for income and expenses respectively neither is the Commissioner. The principle is so entirely just and the law so plain that the point needs no further elaboration, * * *"

Sixth Circuit:

Ohmer Register Company v. *Commissioner*, 131 F. (2d) 682, C. C. A. 6, 1942.

In that case the Court said at page 686:

> "The essence of the accrual method of keeping accounts and making returns is that the right to receive not the actual receipt determines whether an amount should be included in gross income. The right accrues when a right to receive the amount becomes fixed. *Spring City Foundry Co.* v. *Commissioner*, 292 U. S. 182, 184. Correspondingly, the right to deduct an expense item accrues when the fixed obligation is incurred, even though the amount may be diminished by subsequent events. Both sides of the ledger must be treated alike."

The Circuit Court of Appeals, Sixth Circuit, in the case of *Air-Way Electrical Appliance Corporation* v. *Guitteau*, 123 F. 2d 20, C. C. A. 6, 1941 held at page 22:

> "* * * to divide the transaction and to place part of it upon an accrual basis and part of it on a cash basis * * * does not reflect true income."

Tenth Circuit:

> *United States* v. *Amalgamated Sugar Company*, 72 F. (2d) 755 at 759, C. C. A. 10, 1934.

> "The right to receive a definite sum as distinguished from its receipt and the fixed obligation to pay expenses as distinguished from actual payment, accrue items for income tax purposes if taxpayer uses the accrual system of keeping its books of account."

3. The United States Circuit Court of Appeals has decided important questions of Federal Law which have not been, but should, be settled by this Court. These questions are:

(a) Is there a distinction between an obligation to render services and an obligation to pay money? If no such distinction exists, then the decision in the case of *United States* v. *Anderson* (*supra*) and cases in harmony therewith are controlling and the decision herein must be re-

versed. If there is a distinction between these twin obligations, this distinction has never been passed on by this Court and should be settled by it.

The Circuit Court of Appeals made its decision hereupon as follows:

> "The liability for the estimated deduction clearly had not accrued during the year in which deduction was sought. The only thing which had accrued was the obligation to do the work which might result in the estimated indebtedness after the work was performed.
>
> "It is well settled that deduction may only be taken for the year in which the taxpayer's liability to *pay* becomes definite and certain even though the transactions (such as the *contract* in the present case*) which occasioned the liability, may have taken place in an earlier year (citing cases discussed infra). Here the work for which the deduction was sought was unperformed and its cost was, as we have already indicated, no more than a fair estimate. Such a deduction * * * had not 'accrued during the taxable year' * * *"

From the foregoing, we believe it is a fair statement to say that the Circuit Court of Appeals felt that the liability had not accrued because of two facts, viz:

(1) There was no present obligation to *pay*, as distinguished from a present obligation to render services which obligation was recognized by the Court.

(2) The cost of rendering the services was, of necessity "a fair estimate" which the Circuit Court of Appeals implies may not be the basis of an accrued liability.

---

* Lest the Court be misled, it should be pointed out here that petitioner does not, and never did, contend that the expense liabilities in question accrued upon the signing of the contract. Petitioner's contention is that these expenses accrued in the same period as the income which they produced, i.e. when the prepaid income was received it accrued as *gross* income and must be reduced to *net* income in that period by accruing the cost of performing the prepaid work as a deduction.

The Circuit Court of Appeals' distinction between an obligation to render services and an obligation to pay money is an unreal one in both law and accounting. Rendering services necessitates expending money. An obligation to render services is the equivalent of an obligation to pay money. This is expressly recognized by Regulations 101, Article 41-1, applicable herein, which provides:

> "* * * Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. * * *"

The equivalence of an obligation to render services and an obligation to pay money from an accounting standpoint is recognized by Montgomery, Sixth Edition, *Auditing, Theory and Practice,* which states at page 302:

> "When items such as * * * advances received on uncompleted contracts involve a substantial obligation to render services and failure of performance may call for liquidation in cash, or when expenditures will be required within the ensuing period to realize the earning included in the deferred items, there can be no objection to including such items among the current liabilities."

(b) The Tax Court was obliged to determine the correct measure of both income and expense. Then if the said income and expense were found not as reported the correct net income could be determined under the rules of the Tax Court.

In its petition to the Tax Court (Board of Tax Appeals) petitioner set forth in detail all of the facts pertinent to its income and expense for the fiscal year in question and asked that its taxes be determined in accordance with such facts and that the claimed deficiency be declared illegal and void.

On the hearing of this matter petitioner proved in detail the items of both its income and expense.

The Tax Court had before it for determination the question of the net taxable income of petitioner for the year in question. It was its statutory obligation to determine this question.

In this case the Tax Court clearly indicated that petitioner had reported too much income by accruing uncertified contract work performed and had reported too much expense by accruing the expenses in question. It permitted the accrued income to stand but disallowed the accrued expenses in question, thus creating a situation where petitioner would be forced to pay taxes on net income not realized. The Tax Court was obligated to determine (in principle) petitioner's net income.

It has not made this determination.

The Circuit Court of Appeals did not pass on this question and as far as petitioner knows the question has never been passed on by this Court.

4. The Circuit Court of Appeals has so far departed from the accepted and usual course of judicial proceedings, or so far sanctioned such a departure by the Tax Court of the United States as to call for an exercise of this Court's power of supervision.

The findings of the Tax Court are in major and vital respects directly contrary to the unquestioned documentary evidence in this case, viz:

(a) Petitioner proved that its manner of reporting its income and expense from long term contracts was not of its own choosing but was forced upon it by the action of respondent in 1933 (see page 3 hereof).

(b) Petitioner proved that its method of accounting and reporting for the fiscal year in question was consistent with its method of accounting and reporting for previous years.

The Tax Court held:

> "The evidence showed that other instances asserted by petitioner to be similar were in reality no more than proper accruals of actually incurred expenses."

The documentary evidence (the books of petitioner for 1934) show that for that year there was accrued as income retained percentages held by the Treasury Department pending petitioners removing a cofferdam and a $17,000 liability being the estimated cost of removing the same (see Petitioner's Exhibit 20, fol. 724).

The Circuit Court held "the contention that the deduction of future expenses was consistent with the taxpayer's former accrual method of accounting clearly is without substance fortified as it is by only a single entry some years before." (Note: This differs radically from the Tax Court finding.)

[There were other accruals there too, but space does not permit the development of the details thereof.]

(c) Petitioner proved the reasons for accruing retained percentages and the facts concerning the same.

The Tax Court found:

> "It returned as income stipulated percentages which under that contract the City of New York reserved the right to and did retain, and which petitioner could not demand or lay claim to as a matter of right until performance was complete; although under those circumstances the liability to pay was not yet sufficiently definite to warrant accrual (Tr. fol. 251) * * * although the amounts so withheld were greater than the expense items which petitioner seeks to accrue and deduct and would more than offset them * * *" (Tr. fol. 252).
>
> "* * * and for the securing of which it would be required to undertake additional obligations" (Tr. fol. 255).

The documentary evidence (estimates of the City of New York) showed that up to June 11, 1938, petitioner had al-

ready received $444,000 of such retained percentage of $529,818.24 accrued by the substitution of securities (Petitioner's Exhibit 5, sheet 19), and the contract showed that to secure them it would not be required to undertake any additional obligations (Petitioner's Exhibit 3).

The finding in question is contrary to the proven fact.

(d) Petitioner proved that if the accruals of expense in question had not been made there would have been a distortion of income.

The Tax Court held:

> "On the contrary in both theory and result there is every probability that a distortion of income would follow upon the adoption of such a procedure" (Tr. fol. 266).

The documentary evidence (i. e., the bill of particulars taken from petitioner's cost records) shows that the actual cost of the work for which the accruals were made was $339,089.67. Obviously, if the accruals had not been made there would have been a distortion of income. The finding in question is contrary to the proven fact.

All of these facts are major and vital herein.

There is in the record not the slightest shred of evidence to support the above findings of the Tax Court.

It is inconceivable that the Circuit Court of Appeals could affirm a judgment of the Tax Court based on findings of such important character directly contrary to the unquestioned documentary evidence herein.

The Importance of a Review of the Questions Involved Herein

That a review of the questions herein is desirable is indicated by the following quotation from Montgomery Federal Taxes on Corporations, Gross Income and Deduc-

tions, pages 835. With the opinions of Dr. Montgomery, this Court may or may not fully agree. The fact that the author of a standard text on the subject should find it necessary to characterize so critically the actions of respondent and the lower courts as "loaded with inconsistencies" itself shows the need for a restatement by this Court of the principles so well enunciated in the cases of *United States* v. *Anderson* (*supra*) and *American National Company* v. *United States* (*supra*).

This quotation from Montgomery, above referred to, is as follows.

> "The rulings and decision of the Treasury and Board dealing with accruals and the accrual method of accounting are loaded with inconsistencies. The fault has been not so much with the formal regulations as with their administration. When items of income arise or are collected in one period and part of the income belongs to a later period, good accounting practice requires that reserves be set up so that the first period will not have the benefit of unrealized and hence fictitious income * * *. The same mistaken attitude is evident in the Treasury's treatment of certain deferred expenses. * * * The trouble seems to arise from the confusion of 'accrued' with 'due and receivable' and 'due and payable.'
>
> "It is not a matter for legislative relief. There has been adequate relief in the laws for years. Section 41 requires the use of a method of accounting which clearly reflects the income. Section 42 requires the accounting for all items of gross income by proper accounting methods, authorized under Section 41 which clearly reflect the income. Section 43 authorizes the deduction of expense in such period as most clearly reflects the income * * *. The proper approach is admirably set forth in *Bonded Mortgage Co. of Baltimore* v. *Commissioner*, 70 F. (2d) 341.
>
> * * * * * * * * *
>
> "The Treasury in many cases, and the Board at times have ignored the basic principles in *U. S.* v. *Anderson* (269 U. S. 422), which is that the early in-

come tax laws were changed to enable taxpayers 'to keep their books and make their returns according to scientific principles by charging against income earned during the taxable period, the expense incurred and properly attributable to the process of earning income during the period.' " (Montgomery Federal Taxes on Corporations Gross Income and Deductions, p. 835.)

Conclusion

For the reasons stated, it is respectfully submitted the writ of certiorari prayed for herein should be granted to the end that the mandate of the United States Circuit Court of Appeals, Second Circuit, herein may be reviewed and reversed and for such other and further relief as may be just and proper.

October 16, 1944.

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APPENDIX A

Memorandum Findings of Fact and Opinion.

THE TAX COURT OF THE UNITED STATES

Docket No. 108431.

SPENCER, WHITE & PRENTIS, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

EDGAR A. B. SPENCER, Esq., and THOMAS P. MORRISSEY, Esq., for the petitioner.

THOMAS H. LEWIS, JR., Esq., and PATRICK J. CAVANAUGH, Esq., for the respondent.

OPPER, *Judge*: Petitioner in this proceeding challenges respondent's determination of income and excess-profits tax deficiencies in the amounts of $71,828.41 and $34,049.38. respectively, for the fiscal year July 1, 1937, to June 30, 1938. The suestion involved is whether petitioner may deduct as incurred or accrued expenses the sum of $327,500.00 for work or services to be performed subsequent to the tax year in issue.

FINDINGS OF FACT.

Petitioner is a corporation organized July 16, 1919, and existing under the laws of the State of New York, having its principal office at 10 East 40th Street, New York City.

Appendix A.

Its tax return for the period in question was filed with the Collector of Internal Revenue, 3rd New York District.

Petitioner was engaged in the general construction and engineering business, doing the installation of foundations, the underpining of buildings, and short-term construction contracts dealing largely with sub-surface and hydraulic conditions. Although the majority of the contracts performed were short-term contracts completed within one year, prior to December 11, 1933, petitioner had been interested in various long-term contracts as consulting engineers, syndicate participants or as contract managers under service contracts. Its books have been kept and returns made for fiscal years beginning on July 1 and ending on the next succeeding June 30, and always, on the accrual basis.

On December 11, 1933, petitioner applied to the Commissioner for consent to change its method of accounting and reporting in connection with long-term contracts to the completed contract basis. The application was disapproved because it was not submitted within the ninety days after the beginning of the taxable year.

On June 29, 1937, petitioner entered into and in July, 1937, commenced performance of a unit price contract, designated as No. 761 on its books, with the Board of Transportation of the City of New York for subway construction on Route 101, Section 6, which was under 6th Avenue from West 9th Street to West 18th Street in Manhattan. Petitioner was engaged in work on this contract among others during the fiscal year involved.

The contract required performance of thousands of types of operations, but designated specific prices for only a few items which were known as pay items. In making bids under the contract, petitioner included in the bid price for pay items the cost of performing those operations for which no price was specified, and in this manner distributed the cost of operations not specified as pay items

over the pay items to which they were related, or ratably over all the pay items. The non-pay items included such things as the taking up and relaying of sidewalks and roadways, support and maintenance of building, water mains and gas pipes, administration and engineering expenses. The contract was subject to a performance bond and provided for progress payments under Article XXXV and XXXVI, which provided in part as follows:

PAYMENTS TO CONTRACTOR

ARTICLE XXXV. *Partial Estimates.* In order to assist the Contractor to prosecute the work advantageously, the [City] Engineer shall, from time to time as the work progresses, but not more often than once a month, make in writing an estimate such as in his opinion shall be just and fair, of the amount and value of the work done and materials incorporated in the work by the Contractor according to the terms of this contract (but it is understood that in making such estimates the Engineer shall not necessarily be governed by the prices contained in the Schedule of Prices); * * * The first such estimate shall be of the amount and value of the work done and materials incorporated in the work since the Contractor commenced the performance of this contract on his part. Every subsequent estimate except the final estimate shall be of the amount and value of the work done and materials incorporated in the work not included in the last preceding estimate; * * *

ARTICLE XXXVI. *Not by Strict Measurement.* Such estimates shall not be required to be made by strict measurement, but they may be made by measurement or by estimation or partly by one method and partly by the other, and it shall be sufficient if they are approximate only.

Appendix A.

The first certification of work completed by the city was made approximately three months after commencement of work on the contract and certifications were generally made each month thereafter during the period here involved.

Article XXXIII of the contract provided for the retention by the city of 15 percent of the amounts of work certified to be complete as follows:

> ARTICLE XXXIII. *Retained Percentage.* (a) In addition and as further security there shall be deducted and retained 15 per centum of the amounts certified from time to time to be due to the Contractor * * *. Such retained percentages shall be held as further security for the faithful performance by the Contractor of all the conditions, covenants, and requirements specified and provided for in this contract. The Contractor may from time to time withdraw portions of the amounts so retained upon depositing with the Comptroller, United States Government securities or corporate stock or bonds of the City of a market value equal to the amount so withdrawn, in which event the provisions of this Chapter in respect of securities shall apply to such securities deposited. * * *

The city retained 15 percent of the certified amounts in accordance with the above provision. The full amount of retained percentages from the inception of the contract in July, 1937, to June 30, 1938, in the amount shown below, was accrued and entered on petitioner's books as accrued income, and reported on its return as income for the period in question.

The certified estimate of work completed to June 11, 1938, was $3,532,121.58, and to July 11, 1938, was $4,013,590.61. There was no separate certification by the city

of work completed to June 30, 1938, but by interpolation on the basis of the working days involved—petitioner estimated that to be $3,853,641.43 and the amount earned from June 11 through June 30 to be $321,519.85. That amount was included in petitioner's return as part of its gross income, being the gross receipts from contract No. 761. Part of that amount was considered by petitioner to be accrued income, and the total was made up as follows:

(a) Moneys earned under contract certified and paid	$3,002,303.34
(b) Amount certified under contract but retained by the City of New York pursuant to the contract	529,818.24
(c) Amounts not yet certified under contract	321,519.85
	$3,853,641.43

Because of the inclusion, in the contract price of pay items, of the contract cost of other operations which were not completed at the same time as the particular pay item, the petitioner received certifications for progress payments for pay items completed, which included certain amounts which it considered allocable to operations which would be performed subsequent to the pay items for which progress payments were certified.

As of June 30, 1938, petitioner estimated that up to that date the sum of $3,853,641.43 above set forth included payment for certain non-pay operations uncompleted by that date, under the caption "Contract 761 Deferred," and entered on its journal as of June 30, 1938, the following "for incurred expense":

Appendix A.

1. Moving off job, clean up, etc., 60% of $100,000		$60,000.00
2. Repairs to buildings damaged by subway construction and legal expenses, etc.		50,000.00
3. Completion of excavation by removing braces, timbering, sheeting, installing backfill, 91,500 yards @ 1.25		114,500.00
4. Restoration of subsurface structures, damages vault construction		40,000.00
5. Clean up of East Tunnel caulking		15,000.00
6. Supervision, office expenses for 3 mos.		
Electricians, mechanics	$5,000 per mo.	
Overhead	10,000 per mo.	
Office expense	1,000 per mo.	
	$16,000 x 3	48,000.00
Total		$327,500.00

The above total of $327,500 was reported on Schedule X (Balance Sheet) of petitioner's return as "Liability to restore property under contracts." It was also included in the cost of operations in Schedule A (Net Income Computation), with a resulting diminution in net income for excess-profits tax computation.

Costs of contract No. 761 paid and accrued to June 30, 1938, other than the $327,500 above, amounted to $2,860,110.76 and the total cost paid and accrued with respect to that contract as reported by petitioner was the sum of the two figures. The petitioner's estimate was that the contract was 60 per cent complete, whereas after actual completion it was found that the contract was 53.9 percent complete as of June 30, 1938. The sum of $327,500 did not represent obligations to subcontractors, materialmen, labor or any creditor. The work was actually performed after June 30, 1938, at a cost of $339,090.40.

Appendix A.

In his notice of deficiency respondent denied the deduction of the $327,500, stating:

> Unallowable deductions and additional income
> (a) Reserve for expenses $327,500
>
> * * *
>
> (a) The deduction of a reserve of $327,500 for future expenses is held to be unallowable under the provisions of Section 42 of the Revenue Act of 1938, and Article 42-4(a), Regulations 101.

OPINION.

The extent to which petitioner's books and tax returns correctly set forth its gross income from the subway contract is not in issue although it returned as income stipulated percentages which under that contract the City of New York reserved the right to and did retain, and which petitioner could not demand or lay claim to as a matter of right until performance was complete; although under those circumstances the liability to pay was not yet sufficiently definite to warrant accrual, *Cleveland Trinidad Paving Co.*, 20 B. T. A. 772, affirmed (C. C. A., 6th Cir.), 62 Fed. (2d) 85; *Benjamin Franklin Patterson*, 21 B. T. A. 8, although the amounts so withheld were greater than the expense items which petitioner seeks to accrue and deduct, and would more than offset them; and although petitioner's attention was repeatedly drawn to the problem thus involved throughout the progress of the hearing. Nevertheless, petitioner steadfastly refused to place the question in issue, and stood its ground that it was required to report such amounts as income, and that no error existed in that respect and no claim for reduction or elimination of the deficiency was being made on that ground.

Appendix A.

Respondent not unnaturally made no contrary contention, and we accordingly accept for purposes of this proceeding the hypothesis that no adjustment need or can be made in the gross income reported by petitioner. For similar reasons and under similar circumstances, no further notice need be paid to the "interpolated" accrual for work presumed to have been performed between June 11, 1938, when the work done under the contract was estimated for payment by the parties, and June 30, 1938, the close of petitioner's fiscal year, although here the figures of gross income on the one hand and claimed deduction on the other are so close as to be virtually identical.

It does not follow, however, that this aspect of the situation can be overlooked in disposing of petitioner's contention. The explanation given in petitioner's brief for the inclusion of the retained percentage in its reported income is that:

> These sums were included in income, since part of the expense to earn them was carried into expense paid and accrued.

Thus, because some of the expenses of carrying out the contract had actually been paid or incurred and, therefore, were properly accrued, petitioner insists upon returning payments under the contract to which it was not yet entitled, and for the securing of which it would be required to undertake additional obligations. And having returned that income, it insists that such future and unobligated expense must be an appropriate present deduction as an offset against the still inchoate receipts.

In claiming the right to deduct estimated future costs of completing the specified phases of the contract, petitioner's primary postulate accordingly is that the obligation to perform the work for which it claims the right

of accrual arose not merely because of the contract but essentially by force of the circumstance that the future work in question had been paid for in full in advance. The argument thus runs that since the city had paid for the work but petitioner had not yet performed it, two things followed: First, that there accrued against petitioner a liability measured in dollars and cents to perform the work for which it had received payment; and second, that since it had received the money, its net income would be distorted if it did not offset against that the corresponding obligation to render the services for which payment had been received.

But we must consider throughout that the basic premise for this reasoning involves the assumption that the work in question had actually been paid for in full, or at least to a sufficient extent so that the cost of completing the remainder of the work would be greater than the payments yet to be received. It must, of course, be conceded that such was clearly not the case to the extent of any actual receipt of cash. Petitioner's assertion is based on its use of the accrual method of bookkeeping. If, however, the payments still to be made were not properly accrued, they no more form the basis for a premise that the work had been paid for in full, even on an accrued system, than would be the case with a cash basis taxpayer where payments in cash or its equivalent had not yet been realized. It follows in the first place, therefore, that in this proceeding there are not before us the necessary facts upon the strength of which the legal contention advanced by petitioner actually can be supported. And if there is any distortion of income, which is by no means clear, it derives from petitioner's voluntary insistence upon returning unaccruable income, rather than upon the failure to permit the accrual of offsetting deductions.

This is not to say that were it otherwise there would be a sound legal foundation for a determination in petitioner's favor. In those cases where a question somewhat analogous has arisen, the decisions have been uniform in denying to a taxpayer the privilege of accruing items which are not yet in the form of cash liabilities to ascertainable creditors. Thus, in *Amalgamated Housing Corp.*, 37 B. T. A. 815, affirmed (C. C. A., 2nd Cir.), 108 Fed. (2d) 1010, the fact that the petitioner was required to make certain repairs and to redecorate and that its monthly rentals were the source of funds for that purpose was not considered sufficient to justify a deduction of the estimated future cost of defraying the expense of renovation in excess of expenditure actually incurred. "Although the petitioners were obligated to renovate they had no liability to pay anyone anything until someone had performed some services. The accrual is for services in renovating, not of the duty to renovate." Similarly, in *Clay Sewer Pipe Association, Inc.*, 1 T. C. 529, an obligation on the part of petitioner to make expenditures for furnishing services for which it had already received payment was not thought to be sufficient to justify either an exclusion of the amount received from its gross income or the deduction as an accrued liability of the proposed expenditures. "But even so, that it [the petitioner] intended and may have been obligated in the taxable year to expend that excess in later years in furnishing the services for which it was paid in the taxable year, affords no basis for an expense accrual in the earlier year. During the taxable year no such expenditure had been made. No item of future expense had been contracted for." See also *Jahncke Shipbuilding Co.*, 11 B. T. A. 479; *Hallack & Howard Lumber Co.*, 18 B. T. A. 954. As respondent not inaptly suggests, the present petitioner "contends that it should be allowed to deduct an obligation to incur expense in some later period * * *."

Appendix A.

In its main brief petitioner quotes from *In re Harrington,* 1 Fed. (2d) 749, to the effect that "the regular and long-standing methods of accounting employed by the taxpayer, established in due course and for no ulterior purpose, are to be indulged." But it takes the wind out of its own sails by conceding in the reply brief that "It is true that this petitioner never before made accruals exactly the same as made at and as of June 30, 1938, and under discussion herein, and the reason therefor is simple. This was the first time that it had carried out in its own name a subway contract of the Board of Transportation of the City of New York which required such accruals to be made to properly report income." The evidence showed that other instances asserted by petitioner to be similar were in reality no more than proper accruals of actually incurred expenses.

There is some interchange between the parties as to what the effect would have been had petitioner consistently adopted the percentage of completion basis of reporting its income. Since it does not purport to have done so, the discussion is in all likelihood academic. Petitioner complains that an application by it for leave to report on the completed contract basis was denied by respondent. But the denial apparently with respect to an earlier year was communicated to petitioner more than 90 days prior to the commencement of the tax year in issue and gave as its reason that the application in question was not "filed within 90 days of the beginning of the taxable year."

It does appear, however, as petitioner contends with plausibility in its reply brief, that the income it would have been required to report under a percentage of completion system would have included only the proportionate amount of total payments which reflected work actually done. This, of course, would eliminate the present problem; and if so, it may, on the one hand, rebut any sug-

gestion that there was no method by which petitioner could legally record its actual income and, on the other, furnish the explanation why in situations of this kind no contention like the present appears in the discoverable authorities.

That the petitioner has been unable to suggest precedents in its favor, and that neither party has produced a case precisely in point seems to us a powerful rejoinder to the contention that what was done here was either ordinary and usual accounting practice, or a requirement for the accurate reflection of petitioner's net income. The absence of earlier instances in the law books dealing with situations of this character is most easily explained on the assumption that it is not usual or frequent for bookkeepers to indulge in such a practice. On the contrary, in both theory and result there is every probability that a distortion of income would follow upon the adoption of such a procedure. Petitioner's accounting witness was requested to state his theory as to how subsequent accruals for obligations incurred upon performance of the work in question should be treated. He answered:

> There would be a liability for that $327,500 for work and materials actually done and incurred. And since there was no additional cost it would merely mean a transfer from this account that we call in the tax return * * * "liability to restore property under contract" * * *
>
> In other words, you close that account out?
>
> The Witness: We would close that account out and merely substitute for that a liability for the work that had been done but not paid for.

The evidence falls short of establishing definitely that this theory in fact was followed or to what extent, if any, there ever were made against the accrued future liability any counter-balancing entries for liabilities actually in-

curred for the work in question. Of course, if this was not done, it would tend to distort income for later years by presenting petitioner at that time with the equivalent of a double deduction; and even though, upon the termination of the entire contract after a number of years, a balancing entry were made, the failure to make current entries from year to year as liability for the work itself was incurred and the corresponding failure to eliminate from accrual the cost items already compensated for, would tend to distort the income of the intervening years.

But even if the theory had been followed, there still remains the inescapable necessity of distinguishing between the subsequent or new account for liabilities actually incurred which on its face would appear to be a proper and traditional accrual, and the earlier account which petitioner here seeks to deduct, which obviously was of a character so different that the creation of the new account would necessitate the elimination of the old, and which in this respect appears to partake more nearly of the characteristics of a reserve. In other words, if there were a reasonably safe and certain method for accomplishing petitioner's purpose, and at the same time securing the protection of the revenue by providing against future distortion of income through debits of periodic accruals of expenses already deducted, it would seem to be by some system of reserve accounting. This is accordingly no mere matter of the choice of words, but a substantive proposition of real significance.

Yet the treatment employed by petitioner upon the approval of which it now insists is to deduct the disputed items as incurred liabilities. They were not originally characterized as reserves and it is with some asperity that petitioner rejects the attempt to place them in that category now. It says, for example, in its reply brief:

> The use by respondent of the expression "reserve for unincurred costs" is completely unwarranted,

since the items being discussed are "accruals of incurred costs." On the trial hereof, respondent also tried (unsuccessfully) to inject the question of reserves into this case and now does so again.

We are thus precluded from considering whether a reserve under such circumstances might eliminate some of the objections to the procedure to which petitioner has resorted. For a reserve account placed upon the books of the petitioner would necessarily continue to appear thereon until by counter-balancing entries it had been written off. There might thereby be furnished some assurance that when by subsequently incurred expenses petitioner's forecast of future costs actually materialized, they would furnish the occasion for offsetting items in the reserve rather than for deductions from current income, the final outcome of which would enable both petioner and respondent to avoid duplicating deductions and to give appropriate treatment to any closing balance, so that ultimately the exact financial result of the contract could be reflected in the tax returns.

But the continued resistance to the concept of a reserve makes any such eventuality seem unlikely. We remain for this additional reason unpersuaded that the treatment adopted by petitioner was necessary for an accurate reflection of its income. Dealing, as we must, with the narrow issue before us, and laying to one side any speculation concerning the correctness of the gross income reported or the effectiveness that might otherwise have been contributed by the use of a completed contract, or percentage of completion, or even reserve, system, we reach the result that petitioner's claim in the form presented to us cannot be sustained.

Decision will be entered for respondent.

Enter:

Entered June 21 1943

APPENDIX B

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 304—October Term, 1943.

(Argued June 15, 1944 Decided July 10, 1944.)

SPENCER, WHITE & PRENTIS, INC.,

Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

AUGUSTUS N. HAND, CHASE and FRANK,

Circuit Judges.

Petition by Spencer, White & Prentis, Inc., to review an order of the Tax Court of the United States determining deficiencies in its income and excess profits taxes in the amount of $71,828.41 and $34,049.38 respectively for the fiscal year July 1, 1937 to June 30, 1938. Affirmed.

EDGAR A. B. SPENCER, Attorney and counsel for Petitioner, Spencer, White & Prentis, Inc.

SAMUEL O. CLARK, JR., Assistant Attorney General, Sewall Key, Robert N. Anderson and Harry Baum, Special Assistants to the Attorney General, for the Commissioner of Internal Revenue.

Appendix B.

Per Curiam:

The taxpayer is a New York corporation engaged in general construction and engineering business. It installed foundations, underpinned buildings and entered into short term construction contracts dealing with sub-surface and hydraulic conditions. Most of its contracts were short term contracts completed within one year, but it was also interested in various long-term contracts. Its books were kept and its returns made for fiscal years beginning on July 1 and ending the following June 30, but always on the accrual basis. On December 11, 1933, it applied to the Commissioner for a consent to change its method of accounting for long-term contracts to the completed contract basis but failed to obtain a consent because the application was not submitted within ninety days after the beginning of the taxable year as required by Article 41-2 of Treasury Regulations 94, promulgated under the Revenue Act of 1936.

On June 29, 1937 the taxpayer entered into and in July 1937 began to perform a unit price contract with the Board of Transportation of the City of New York for subway construction under Sixth Avenue, from West 9th Street toWest 18th Street, in the Borough of Manhattan. It was engaged in work on this contract during the fiscal year ended June 30, 1938. The contract required the performance of thousands of types of operations, only some of which were known as pay items. In making bids under the contract, the taxpayer included in the bid prices for pay items the cost of those operations for which no price was specified and in this manner distributed the cost of the operations not specified as pay items over the pay items to which they were related or ratably over all the pay items. The non-pay items included such things as the taking up and relaying of sidewalks and roadways, support and maintenance of buildings, water mains and gaspipes and administration and engineering expenses.

Appendix B.

The contract provided for progress payments to the taxpayer based upon certified partial estimates, to be made from time to time by the city engineer, of the value of the work done and materials incorporated in the work. The first certification of work completed was made approximately three months after the work was begun and certificates were generally made each month thereafter. The contract was subject to a performance bond and as further security to retention by the City of 15% of the amounts certified.

The taxpayer in its income tax statement returned as gross income, accrued under the contract during the fiscal year July 1, 1937 to June 30, 1938 inclusive, a total which was made up as follows:

(a)	Moneys earned under contract certified and paid	$3,002,303.34
(b)	Amount certified under contract but retained by the City	529,818.24
(c)	Amount earned but not yet certified	321,519.85
		$3,853,641.43

The total of $3,853,641.43 included by the taxpayer as gross income in its return for the fiscal year in question covered not only the contract price for pay items completed but some non-pay items yet to be performed. This resulted from the fact that the cost of non-pay items was included in the cost of pay items.

The taxpayer accrued on its books as of June 30, 1938, the sum of $327,500 as a "liability to restore property under contracts" which was the estimated cost of items which it had carried in its accrual of gross income. This amount of $327,500 it deducted in its tax return as "increased expenses". But this amount did not represent obligations due

to sub-contractors, materialmen, laborers or other creditors and was an estimate of the cost of work under the contract performed after June 30, 1938, at a cost of $339,090.40. The Commissioner disallowed the deduction and assessed a deficiency in the taxpayer's income tax of $71,828.41 and in its excess profits tax of $34,049.38 and the Tax Court reached the same result as the Commissioner.

The question before us on this appeal is whether the estimated future cost of work which had not been performed in the fiscal year ending June 30, 1938, was a proper accrual deduction from the income of that year. We think that under the authorities the Commissioner and the Tax Court were right in disallowing the deduction and that the order determining the foregoing deficiencies against the taxpayer should be affirmed.

It is conceded that the receipts by the taxpayer, though they exceeded the amount due for the work that had been performed under the contract were properly returned as income. But the fact that payments would have to be made by the taxpayer in a future year for work which had not been done in the year in question did not give rise to a proper tax deduction. It is argued that it did give rise to such a deduction because a liability existed to perform the work during that year. This theory, however, proves too much, for under it a taxpayer on the accrual basis could estimate the entire gross income which might be received from his contract, though no work had been begun, could deduct the estimated expense of performance and could compute the taxes accordingly. In other words, if an estimate was possible, there would be room to make returns involving anticipated results of great uncertainty. Moreover, if the taxpayer's theory were applied consistently, in the present case, the income derived from the contract would have to be returned for the fiscal year ending June 30, 1937, rather than for the year ending June 30, 1938, be-

cause the contract went into effect during the former year and the obligations of the parties then became fixed *inter sese.*

The difficulty with the taxpayer's claim is that it ignores the fact that our income tax law is based upon annual periods of computation and that it seeks to have the taxes computed under a system which Justice Roberts, in *Security Flour Mills Co.* v. *Commissioner,* 321 U. S. 281, 287, termed "partly annual and partly transactional". In *Dixie Pine Products Co.* v. *Commissioner,* 320 U. S. 516, 519, the same Justice said: "It has never been questioned that a taxpayer who accounts on an accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year. It has long been held that in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid; * * *". The liability for the estimated deduction clearly had not accrued during the year in which deduction was sought. The only thing which had accrued was the obligation to do the work which might result in the estimated indebtedness after the work was performed.

It is well settled that deductions may only be taken for the year in which the taxpayer's liability to pay becomes definite and certain, even though the transactions (such as the contract in the present case) which occasioned the liability, may have taken place in an earlier year. *Brown* v. *Helvering,* 291 U. S. 193; *American Hotels Corp.* v. *Commissioner,* 134 F. (2d) 817; *Amalgamated Housing Corp* v. *Commissioner,* 37 B. T. A. 817, aff'd 108 F. (2d) 1010; cf. *Security Flour Mills Co.* v. *Commissioner,* 321 U. S. 281, 287; *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359. Here the work for which the deduction is sought was unperformed and its cost was, as we have already indicated, no

more than a fair estimate. Such a deducation as the taxpayer seeks had not "accrued during the taxable year" and, therefore, did not meet the requirements of Section 23(a) of the Revenue Act of 1936.

The petitioner's reliance upon *United States* v. *Anderson*, 269 U. S. 422, is misplaced. There the deduction of certain estimated tax liabilities set up in a reserve entered on the taxpayer's books in accordance with a Treasury Regulation was allowed, though the taxes had not been assessed. But all the events had occurred which determined the liability to pay the tax. Here liability for the work done after July 1, 1938, had not been incurred for the work had not been performed. Cf. *Lucas* v. *American Code Co.*, 280 U. S. 445.

The contention that the deduction of future expenses was consistent with the taxpayer's former accrual method of accounting clearly is without substance fortified as it is by only a single entry some years before. The claim that the Tax Court erred in its findings and in its failure to make certain findings is likewise without merit. The contention seems to rest on a confusion of facts with conclusions of law.

The order of the Tax Court is affirmed.

APPENDIX C

Statutes Involved

REVENUE ACT—1936

Sec. 21. Net Income.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

"(a) EXPENSES—

(1) IN GENERAL.—All *the ordinary and necessary expenses paid or incurred* during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

"PART IV—ACCOUNTING PERIODS AND METHODS OF ACCOUNTINNG

"Sec. 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

"Sec. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

"The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer. * * *"

"Sec. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

"The deductions and credits (other than the dividends paid credit provided in section 27) provided for

in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

The Regulations Involved

Regulations 94—The Regulations of respondent for the year in question provided as follows:

"Art. 21-1. Meaning of income. * * *

"(d). The normal taxes and surtaxes imposed on individuals and on corporations are computed upon net income less certain credits. Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory net income is commercial net income. This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer (see section 41).

"Art. 23(a)-1. Business expenses.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 23(b)-1 to 23(q)-1.

"Art. 41.1. Computation of net income.—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation can be valued in terms of money. The time as of which any item of

gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. *If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for* (See article 42-1 to 42-3)" (Italics ours).

* * * * * * *

"Art. 41-2. Bases of computation and changes in accounting methods.—*Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income . A method of accounting will not however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency.* See section 48 for definitions of 'paid or accrued' and 'paid or incurred.' *All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly,* unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * * A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction See articles 42.2 and 42.3) * * * (Italics ours).

"The true income, computed under the Act and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return."

"Art. 41-3. Methods of accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that *each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose.* Each taxpayer is required by law to make

a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so (See section 54 and article 54-1) (Italics ours).

"Art. 43.1. 'Paid or incurred' and 'paid or accrued.'—(a) The terms 'paid or incurred' and 'paid or accrued' will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer (See section 48(c).) The deductions and credits provided for in Title I (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', unless in order to clearly reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was 'paid or accrued' or 'paid or incurred', he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner. * * *"

"Art. 43-2. When charges deductible.—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudications, such as decisions of referees and boards of review under work-

men's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise * * *."

I. T. 1273.

I. T. 1273-1—C. B. page 10, in so far as applicable herein reads as follows:

"A taxpayer who reports on the accrual basis takes all deductions at the time they accrue. There must be an actual liability incurred before any amount may be accrued. Where a liability has actually been incurred and is uncertain only as to the exact amount and the exact date it must be discharged, an amount representing a reasonable estimate may be set up as an accrual. On the other hand, if an actual liability is not incurred until the happening of some contingency, no amount can be accrued until the contingency happens."

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In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 612

SPENCER, WHITE & PRENTIS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 78–91) is not reported. The opinion of the Circuit Court of Appeals (R. 265–269) is reported in 144 F. 2d 45.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 27, 1944 (R. 271). The petition for a writ of certiorari was filed on October 19, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Taxpayer, keeping its books and filing its returns on the accrual basis, was obligated to perform certain additional work in completing a contract, for which it would not be further reimbursed. However, no liability for the necessary labor and materials had been incurred. The question is whether taxpayer is entitled under Sections 23 (a) and 43 of the Revenue Act of 1936 to deduct the estimated cost of future performance as an expense incurred during the taxable year.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations appear in the Appendix, *infra,* pp. 11–15.

STATEMENT

Taxpayer is a New York corporation organized in 1919 and engaged in the general construction and engineering business. Its books have always been kept and its returns made on the accrual basis, and for fiscal years beginning July 1 and ending June 30. (R. 78, 79.)

The majority of the contracts received by taxpayer were short-term contracts completed within one year, but it was also interested in various long-term contracts. On December 11, 1933, it applied to the Commissioner of Internal Revenue for consent to change its method of accounting and reporting in connection with long-term con-

tracts to the completed contract basis. The application was disapproved because it was not submitted within the requisite 90-day period after the beginning of the taxable year. (R. 79.)

On June 29, 1937, taxpayer entered into a "unit price" contract with the City of New York for subway construction, and commenced performance in July of that year. Taxpayer was engaged in work on this contract (designated as No. 761 on its books) and on other contracts during the fiscal year ending June 30, 1938. The contract required the performance of thousands of types of operations, only some of which, known as "pay items," had specified prices. Taxpayer included in its bid price for the so-called pay items the cost of performing operations not specified as pay items, thereby distributing the cost of performing non-pay items over the pay items. The non-pay items included such things as the taking up and relaying of sidewalks, water mains and gas pipes, and general administration and engineering expenses. (R. 79–80.)

The contract provided for progress payments to taxpayer based upon certified partial estimates, to be made from time to time by the city engineer, of the value of the work done and materials incorporated in the work. The first certification of work completed was made approximately three months after work was started and certifications were generally made each month thereafter. The

contract was subject to a performance bond and as further security provided for retention by the city of 15% of the amounts certified. (R. 80–81.)

There was no separate certification by the city of work completed as of June 30, 1938, but there were certified estimates as of June 11, 1938, and July 11, 1938. Taxpayer included in its gross income returned for the fiscal year ending June 30, 1938, the sum of $3,853,641.43, made up as follows: (1) $3,002,303.34, representing the amounts certified and paid to June 11, 1938; (2) $529,818.24 representing the percentage retained by the city out of the amounts certified to that date; and (3) $321,519.85, representing the amount earned from June 11, 1938, to June 30, 1938. The last figure was reached on the basis of the certifications of work completed as of June 11, 1938, and July 11, 1938, respectively, and on the basis of the number of working days between June 11 and June 30. (R. 81–82.)

The total of $3,853,641.43 certified for the fiscal year ending June 30, 1938, and included by taxpayer as gross income in its return for that year covered not only the contract price of "pay items" completed, but some non-pay items yet to be performed. This resulted from the fact that the cost of non-pay items was included in the contract price of the pay items. Taxpayer estimated that the future cost of performing these uncompleted operations would total $327,500. (R. 82–83.) As

of June 30, 1938, under the caption "Contract 761 Deferred," taxpayer entered on its journal the following as "for incurred expense" (R. 83):

1. Moving off job, clean up, etc., 60% of $100,000		$60,000.00
2. Repairs to buildings damaged by subway construction and legal expenses, etc		50,000.00
3. Completion of excavation by removing braces, timbering, sheeting, installing backfill, 91,500 yards @ 1.25		114,500.00
4. Restoration of subsurface structures, damages vault construction		40,000.00
5. Clean up of East Tunnel Caulking		15,000.00
6. Supervision, office expenses for 3 mos.		
Electricians, mechanics	$5,000 per mo.	
Overhead	10,000 per mo.	
Office expense	1,000 per mo.	
	$16,000×3	48,000.00
Total		$327,500.00

The above total of $327,500 was reported on Schedule N (Balance Sheet) of taxpayer's return as "Liability to restore property under contracts." It was also included in the cost of operations in Schedule A (Net Income Computation), with a resulting diminution in net income for excess profits tax computation. (R. 83.)

The sum of $327,500 deducted for "incurred expense" did not represent obligations to subcontractors, materialmen, laborers, or any other creditor. The work was actually performed after June 30, 1938, at a cost of $339,090.40. Taxpayer had estimated that as of June 30, 1938, the contract was 60% completed; after actual completion it was found that it was then 53.9% completed. (R. 83.)

Taxpayer's costs under the construction contract paid and accrued to June 30, 1938, apart from the $327,500 entered on its journal as above, amounted to $2,860,110.76. In its return for the fiscal year ended June 30, 1938, taxpayer, in addition to deducting that amount, treated the $327,500 estimated cost of future work as an accrued expense and also deducted that sum from its gross income for that year. The Commissioner disallowed the $327,500 deduction for future expenses and computed a deficiency in taxpayer's income and excess profits tax in the amounts of $71,828.41 and $34,049.38, respectively. (R. 39–43, 83–84.) The Tax Court sustained the Commissioner's determination (R. 92), and the Circuit Court of Appeals affirmed (R. 270–271).

ARGUMENT

1. Taxpayer's assertion (Pet. 6) that the decision below is "probably in conflict" with decisions of this Court is without substance. To reflect taxable income on the accrual basis for a given year "all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid." *Dixie Pine Co.* v. *Commissioner,* 320 U. S. 516, 519; see also *Security Mills Co.* v. *Commissioner,* 321 U. S. 281; *Brown* v. *Helvering,* 291 U. S. 193; *Lucas* v. *Ox Fibre Brush Co.,* 281 U. S. 115; *Lucas* v. *American Code Co.,* 280 U. S. 445. Neither *United States* v. *An-*

derson, 269 U. S. 422, nor *American National Co.* v. *United States,* 274 U. S. 99, upon which taxpayer relies (Pet. 7–8), holds otherwise. In the *Anderson* case it was held that a liability for a munitions tax had been incurred in the year prior to assessment because (269 U. S. at p. 441) all the events had occurred in that year which fixed the taxpayer's liability to pay the tax and its amount. Similarly, in the *American National Company* case a bonus expense was held deductible because the taxpayer's obligation to pay and the amount payable became definite in the year of deduction. Both of these cases were distinguished by this Court in *Lucas* v. *Ox Fibre Brush Co.,* 281 U. S. 115, and *Lucas* v. *American Code Co.,* 280 U. S. 445; they were cited in *Dixie Pine Co.* v. *Commissioner,* 320 U. S. 516, 519, note 6, as illustrative of the long settled principle there reaffirmed. Where, as in the instant case, the items deducted represented an estimated amount of anticipated expenses to be incurred in furnishing work and materials in a later year (R. 82–83), not even the fact of liability is established and the deduction is clearly premature. There was no existing debt to accrue.

That taxpayer was obligated to furnish the work and materials to the City of New York without further compensation does not, as it urges (Pet. 8, 10–11), warrant an offsetting deduction in the taxable year of the estimated future expense of performance, for it is fundamental that income

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is to be determined and taxed on an annual, not a transactional, basis. *Security Mills Co.* v. *Commissioner,* 321 U. S. 281; *Heiner* v. *Mellon,* 304 U. S. 271; *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359. This principle requires that payments received under a claim of right and without restriction as to their use be reported by a taxpayer on the accrual basis in the year received, notwithstanding that he may later be required to restore the payments or their equivalent. *North American Oil* v. *Burnet,* 286 U. S. 417; *Brown* v. *Helvering,* 291 U. S. 193. By the same token, the taxability of a payment for services may not be defeated by cutting across annual accounting periods and relating back expenses incurred in a later year in performing the services. *Clay Sewer Pipe Ass'n* v. *Commisioner,* 139 F. 2d 130 (C. C. A. 3d); *Amalgamated Housing Corp.* v. *Commissioner,* 37 B. T. A. 817, affirmed, 108 F. 2d 1010 (C. C. A. 2d). Neither items of income nor outgo may be accelerated or postponed in order to reflect the net result of a given transaction. *Security Mills Co.* v. *Commissioner,* 321 U. S. 281.[1]

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[1] Permission to change from the accrual to the "long-term contract" method of accounting may, under certain conditions, be granted by the Commissioner. See Article 41–2 of Treasury Regulations 94 under the 1936 Act (Appendix, *infra,* pp. 13–14). Taxpayer in 1933 applied for such permission under the corresponding Article 322 of Treasury Regulations 77 under the 1932 Act, but the application was denied because not timely filed (R. 79, 214–217, 252–258).

2. The decision below does not conflict, as taxpayer alleges (Pet. 9–10), with *Bonded Mortgage Co.* v. *Commissioner,* 70 F. 2d 341 (C. C. A. 4th), *Ohmer Register Co.* v. *Commissioner,* 131 F. 2d 682 (C. C. A. 6th), *Air-Way Electric Appliance Corp.* v. *Guitteau,* 123 F. 2d 20 (C. C. A. 6th), or *United States* v. *Amalgamated Sugar Co.,* 72 F. 2d 755 (C. C. A. 10th.) The extracts cited from those decisions merely express the general principles of accrual which were followed by the court below.

3. Taxpayer attempts (Pet. 12–13) to inject a question concerning the amount of gross income to be reported. The only issue raised by the Commissioner's deficiency notice (R. 39–43) and the pleadings, and to which the Tax Court addressed itself (R. 84), was the propriety of the claimed deduction. The Tax Court did volunteer the suggestion that taxpayer might have overstated gross income by including in payments received from the city amounts certified but withheld as security (R. 84), but taxpayer insisted that it correctly reported gross income (R. 84–85). The Tax Court held that the deduction was not allowable in any event (R. 87). The Circuit Court of Appeals likewise addressed itself (R. 267) to the single issue raised by the Commissioner's disallowance of the deduction.

4. There is no merit in taxpayer's contention (Pet. 13–15) that the Tax Court's findings of fact

are unsupported by substantial evidence. The material facts are not in dispute. As the court below pointed out (R. 269), "The contention seems to rest on a confusion of facts with conclusions of law."

5. Taxpayer's assertion (Pet. 15–17) that this case presents an important question is predicated upon nothing more than the suggestion that the decision below is not in accord with the comment by an author of a text on taxation, whose cited views concerning Section 43 of the Revenue Acts are inconsistent with *Security Mills* v. *Commissioner,* 321 U. S. 281.

CONCLUSION

There is no occasion for further review. The decision below is controlled by settled principles of tax accounting. Neither a conflict of decisions nor a question of general importance is presented. The petition should be denied.

Respectfully submitted.

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NOVEMBER 1944.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.

* * * * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been

so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

SEC. 48. DEFINITIONS.

When used in this title—

(a) *Taxable Year.*—*"Taxable year"* means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. * * *

* * * * *

(c) *Paid, Incurred, Accrued.*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 41–2. *Bases of computation and changes in accounting methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. * * *
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> A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this article, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see articles 22 (c)–1 to 22 (c)–8); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in

the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see article 42–4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see articles 22 (a)–7 and 23 (a)–11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected.

* * * * *

ART. 43–1. *"Paid or incurred" and "paid or accrued."*—(*a*) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a

credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * * * *

ART. 43–2. *When charges deductible.*— Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. * * *

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